

RIA Special Study: Key tax changes in the American Recovery and Reinvestment Act of 2009

The American Recovery and Reinvestment Act of 2009 (the Recovery Act), which was signed into law by the President on Feb. 17, 2009, includes many tax breaks for businesses and individuals as well as energy incentives. This *Special Study* summarizes the most widely applicable changes for businesses and individuals.

Tax Changes for Business

Additional 50% first-year depreciation OK'd for most types of new depreciable property placed in service in 2009. Under pre-Act law, for property placed in service after Dec. 31, 2007 and before Jan. 1, 2009 (Jan. 1, 2010 for certain longer-lived property), an additional depreciation deduction under Code Sec. 168(k) was allowed in the placed-in-service year equal to 50% of the adjusted basis of "qualified property."

New law. For property placed in service after Dec. 31, 2008, in tax years ending after that date, the Recovery Act provides an additional depreciation deduction in the placed-in-service year equal to 50% of the adjusted basis of "qualified property." (Code Sec. 168(k)(1), as amended by Act Sec. 1201(a)) The property generally must be acquired before Jan. 1, 2010 and must be placed in service before Jan. 1, 2010 (before Jan. 1, 2011 for certain longer-lived property).

RIA observation: "Qualified property" as defined in Code Sec. 168(k)(2), includes most types of new property other than buildings.

There is no AMT depreciation adjustment for qualified property recovered under Code Sec. 168(k), which provides for the additional 50% first-year depreciation allowance. (Code Sec. 168(k)(2)(G))

To qualify for bonus first year depreciation:

... The original use of the property must commence with the taxpayer after Dec. 31, 2007. (Code Sec. 168(k)(2)(A))

... The taxpayer generally must purchase the property (a) after Dec. 31, 2007, and before Jan. 1, 2010, but only if no binding written contract for the acquisition was in effect before Jan. 1, 2008, or (b) pursuant to a binding written contract which was entered into after Dec. 31, 2007, and before Jan. 1, 2010.

... The property generally must be placed in service after Dec. 31, 2007, and before Jan. 1, 2010. An extension of the placed in service date of one year (i.e., to Jan. 1, 2011) applies to certain property with a recovery period of ten years or longer and certain transportation property. (Code Sec. 168(k)(2)(B), Code Sec. 168(k)(2)(C))

Retroactively effective for vehicles bought and placed in service after 2008 and before 2010, the Recovery Act also increases by \$8,000 the first-year depreciation dollar limit for a passenger auto that is "qualified property" meeting the original use and acquisition and placed-in-service requirements (explained above). (Code Sec. 168(k)(2)(F)(i))

RIA observation: The inflation-adjusted dollar caps for 2009 have not been released yet by IRS. If the inflation-adjusted dollar caps for 2009 are the same as for 2008, the maximum first-year depreciation allowance for a vehicle that's qualified property would be \$10,960 for a new passenger auto acquired and placed in service in 2009, and used entirely for business; for a light truck or van the limit would be \$11,160.

One-year optional extension of election to trade bonus and accelerated depreciation for otherwise-deferred credits. A corporation can, under the Code Sec. 168(k)(4) election that is made for its first tax year ending after Mar. 31, 2008, but also covers all later tax years, choose to forego bonus and accelerated depreciation for "eligible qualified property" in exchange for the present allowance, as refundable tax credits, of otherwise-deferred "pre-2006 credits" (research credits from

tax years beginning before 2006 and credits for AMT paid that is attributable to tax years beginning before 2006).

In general, “eligible qualified property” is defined by reference to “qualified property” as defined for bonus depreciation purposes. Thus, under pre-Act law, both qualified property and eligible qualified property didn’t include property placed in service after Dec. 31, 2008, except for certain aircraft and certain long-production-period property that had, instead, a Dec. 31, 2009 placed-in-service deadline (the placed-in-service rule).

Under the progress expenditure rule for qualified property, long-production-period property could qualify for the Dec. 31, 2009 placed-in-service deadline only to the extent of adjusted basis attributable to manufacture, construction or production before Jan. 1, 2009. Under the progress expenditure rule for eligible qualified property, long-production-period property could qualify for the Dec. 31, 2009 placed-in-service deadline only to the extent of adjusted basis attributable to manufacture, construction or production before Jan. 1, 2009 and after Mar. 31, 2008.

New law. For property placed in service after Dec. 31, 2008, in tax years ending after that date, the Recovery Act expands the definition of “eligible qualified property” by:

- (1) changing the placed-in-service deadline for “qualified property” to Dec. 31, 2009, but for aircraft and long-production-period property, to Dec. 31, 2010, (Code Sec. 168(k)(2)(A)(iv), as amended by Act Sec. 1201(a)); and
- (2) changing the progress expenditure rule for eligible qualified property to provide that long-production-period property can qualify for the Dec. 31, 2010 placed-in-service deadline only to the extent of adjusted basis attributable to manufacture, construction or production after Mar. 31, 2008 and before Jan. 1, 2010. (Code Sec. 168(k)(4)(D)(iii), as amended by Act Sec. 1201(b))

RIA observation: The effect of the above changes on the Code Sec. 168(k)(4) election is to extend the election to cover property placed in service by Dec. 31, 2009 (Dec. 31, 2010 for aircraft and long-production-period property discussed above) instead of, as under pre-Act law, property placed in service by Dec. 31, 2008 (Dec. 31, 2009 for aircraft and long-production-period property). However, taxpayers can decline the extension (see below).

Option to decline the extension. A taxpayer that made the Code Sec. 168(k)(4) election for the first tax year ending after Mar. 31, 2008 may elect to not have Code Sec. 168(k)(4) apply to “extension property.” (Code Sec. 168(k)(4)(H)(i))

“Extension property” is property which is eligible qualified property solely by reason of the changes listed as items (1) and (2) above. (Code Sec. 168(k)(4)(H)(iii))

RIA observation: Thus, a taxpayer that made the Code Sec. 168(k)(4) election for the first tax year ending after Mar. 31, 2008 has the option of not applying the election to property that is eligible for the election solely because the election was extended as described above.

If a taxpayer doesn’t make the election to decline the extension of the Code Sec. 168(k)(4) election, a separate bonus depreciation amount, maximum amount, and maximum increase amount are computed and applied for eligible qualified property that is extension property and eligible qualified property that isn’t extension property. (Code Sec. 168(k)(4)(H)(i)(II))

RIA observation: An effect of separate computations for eligible qualified property that is extension property and for eligible extension property that isn’t extension property would appear to be the possibility of cumulatively doubling the amount of otherwise deferred pre-2006 credits that are presently allowed as refundable credits under the election.

Post-2008 election to trade bonus and accelerated depreciation for otherwise-deferred credits is allowed if an earlier election wasn’t made. For property placed in service after Dec. 31, 2008, in tax years ending after that date, the Recovery Act provides that if a taxpayer didn’t make the Code Sec. 168(k)(4) election for its first tax year ending after Mar. 31, 2008:

... the taxpayer may make the Code Sec. 168(k)(4) election for its first tax year ending after Dec. 31, 2008 and each later year; and

... in that case, the election applies only to eligible qualified property that is “extension property.” (Code Sec. 168(k)(4)(H)(ii), as amended by Act Sec. 1201(b)(2))

Boosted Code Sec. 179 expensing for 2009. Under pre-Act law, the non-indexed annual expensing limit under Code Sec. 179 for tax years beginning in 2008 was \$250,000, but it dropped to \$125,000 for tax years beginning after 2008 and before 2011, with this amount annually adjusted for inflation (for tax years beginning after 2008). For tax years beginning after 2010, the maximum amount will be \$25,000, with no annual adjustment for inflation. The maximum annual expensing amount generally is reduced dollar-for-dollar by the amount of section 179 property placed in service during the tax year in excess of a specified investment ceiling. For tax years beginning in 2008, the investment ceiling limitation was \$800,000, but under pre-Act law, for tax years beginning after 2008 and before 2011, it dropped to \$500,000, as annually adjusted for inflation (starting in tax years beginning after 2008). For tax years beginning after 2010, the investment ceiling limit will be \$200,000, with no annual adjustment for inflation.

The maximum regular Section 179 expensing election amount is increased by \$35,000 for: (a) qualified zone property of an enterprise zone business under Code Sec. 1397(a)(1); and (b) qualified renewal property acquired after 2001 and before 2010, and placed in service in a renewal community, under Code Sec. 1400J. In addition, the amount taken into account under the investment-ceiling phaseout rule is 50% of the cost of such property. Under Code Sec. 179(e), the expensing allowance is increased by \$100,000, and the investment ceiling limit is increased by \$600,000, for qualified disaster assistance property placed in service after Dec. 31, 2007, with respect to disasters declared after that date and before Jan. 1, 2010.

New law. For tax years beginning in 2009, the Recovery Act increases the expensing limit to \$250,000 and the investment ceiling limit to \$800,000. The \$250,000 and \$800,000 amounts are not indexed for inflation. (Code Sec. 179(b)(7), as amended by Act Sec. 1202)

RIA observation: Under the Recovery Act, most small businesses, and even some moderate sized businesses with moderate capital equipment needs, may be able to claim a full deduction for the cost of business machinery and equipment purchased in 2009, thereby reducing their effective cost for the assets. What is more, there is no alternative minimum tax adjustment for property expensed under Code Sec. 179.

RIA observation: The increased expensing and ceiling limits under the Recovery Act also affect the special expensing rules for enterprise zone property, renewal property, and for qualified disaster assistance property. Thus, the maximum expensing allowance for qualified disaster assistance property is \$350,000 for 2009 (\$250,000 + \$100,000), and the investment ceiling limit is \$1,400,000 for 2009 (\$800,000 + \$600,000). The maximum expensing allowance for qualified enterprise zone and renewal property is \$285,000 for 2009 (\$250,000 + \$35,000), with only 50% of the property taken into account in applying the investment ceiling limit.

Small businesses may elect longer NOL carryback period. In general, net operating losses (NOLs) may be carried back two years and forward 20 years. Different rules apply for certain types of losses. For example, a three-year carryback is allowed for an “eligible loss,” including an individual’s loss from casualty or theft and a farm or small business loss attributable to federally declared disasters. A five-year carryback is allowed for a “farming loss,” a “qualified disaster loss,” and certain amounts related to specified disasters. Certain NOLs can’t be carried back at all—e.g., NOLs attributable to interest allocable to a corporate equity reduction transaction (CERT) (so-called “excess interest losses”).

New law. For NOLs arising in tax years ending after Dec. 31, 2007, the Recovery Act permits small businesses to elect to increase the NOL carryback period for an applicable 2008 NOL (the “applicable NOL”) from 2 years to any whole number of years which is more than 2 and less than 6. (Code Sec. 172(b)(1)(H), as amended by Act Sec. 1211(a))

A small business for this purpose is defined as a corporation or partnership that meets the gross receipts test of Code Sec. 448(c) (applied by substituting \$15 million for \$5 million) for the tax year in

which the loss arose, or a sole proprietorship that would meet that test if the proprietorship were a corporation. This means any trade or business (including one conducted in or through a corporation, partnership, or sole proprietorship) whose average annual gross receipts (under Code Sec. 448(c), as modified) for the three-tax-year period (or shorter period of existence) ending with the tax year before the year in which the loss arose are \$15 million or less.

RIA observation: The increased carryback period can generate a refund for a small business because it allows the taxpayer to offset income that has already been taxed. Under pre-Act law, a taxpayer couldn't use the NOL to offset the taxable income for the fifth, fourth, and third tax years preceding the NOL year, and so couldn't have received a refund of the tax paid on those amounts.

An applicable 2008 NOL is the taxpayer's NOL for: (1) any tax year ending in 2008; or (2) at the taxpayer's election, any tax year beginning in 2008. (Code Sec. 172(b)(1)(H)(ii)(II))

If a corporation has a corporate equity reduction transaction (a CERT, i.e., a major stock acquisition or an excess distribution) and an "excess interest loss" (i.e., interest allocable to the CERT) for a "loss limitation year," the loss is an NOL. It's subject to the regular NOL carryback and carryover rules, except that it can't be carried back to a tax year before the year in which the CERT occurred. The "loss limitation year" is generally the tax year in which the CERT occurred (the "CERT year") and each of the next two tax years. Under the Recovery Act, if an eligible small business makes a Code Sec. 172(b)(1)(H) election to increase the carryback for an applicable 2008 NOL, then Code Sec. 172(b)(1)(E)(ii) (which defines "loss limitation year") is applied by using the whole number that is one less than the number of years the taxpayer elected as the carryback for the NOL instead of "two." (Code Sec. 172(b)(1)(H)(i)(II))

The Recovery Act also provides that Code Sec. 172(b)(1)(F) (3-year NOL carryback for "eligible losses," including an individual's loss from casualty or theft and a farm or small business loss attributable to federally declared disasters) doesn't apply to an applicable 2008 NOL for which a small business taxpayer has made a Code Sec. 172(b)(1)(H) election. (Code Sec. 172(b)(1)(H)(i)(III))

Transition rules. Act Sec. 1211(d)(2) provides that for a NOL from a tax year ending before Feb. 17, 2009:

... any election made under Code Sec. 172(b)(3) to waive the carryback period with respect to such loss may be revoked before Apr. 18, 2009 (the date which is 60 days after the Feb. 17, 2009 enactment date);

... any election to increase the carryback period under Code Sec. 172(b)(1)(H) is treated as timely made if made before Apr. 18, 2009; and

... any application for a tentative carryback adjustment under Code Sec. 6411(a) with respect to such loss is treated as timely filed if filed before Apr. 18, 2009.

Reduced estimated tax burden in 2009 for individuals with small businesses. To the extent that tax isn't collected through withholding, taxpayers generally are required to make quarterly estimated payments of tax, in an amount determined by the required annual payment. The required annual payment is the lesser of 90% of the tax shown on the return or 100% of the tax shown on the return for the prior tax year. However, under Code Sec. 6654(d)(1)(C), the prior-year percentage is 110% if adjusted gross income (AGI) for the preceding year exceeded \$150,000).

Taxpayers are not liable for a penalty for the failure to pay estimated tax in certain circumstances (e.g., for U.S. persons who did not have a tax liability the preceding year; if the tax shown on the return for the tax year, or (if no return is filed, the tax), reduced by withholding, is less than \$1,000; or the taxpayer is a recently retired or disabled person who satisfies the reasonable cause exception).

New law. Effective on Feb. 17, 2009, the Recovery Act provides that notwithstanding Code Sec. 6654(d)(1)(C), for any tax year beginning in 2009, in computing the amount of the required annual installments of estimated income tax of any qualified individual, "required annual payment" means the lesser of (1) 90% of the tax shown on the return for the tax year, or (2) 90% of the tax shown on the return of the individual for the preceding tax year. (Code Sec. 6654(d)(1)(D), as amended by Act Sec. 1212)

A qualified individual is any individual if the AGI on the tax return for the preceding tax year is less than \$500,000 (\$250,000 if married filing separately) and the individual certifies that at least 50% of the gross income shown on the return for the preceding tax year was income from a small trade or business. For estates and trusts, AGI is determined under Code Sec. 67(e). A small trade or business is one that employed no more than 500 persons, on average, during the calendar year ending in or with the preceding tax year. (Code Sec. 6654(d)(1)(D)(iii))

Targeted group added to work opportunity tax credit. The work opportunity tax credit is available before September 2011 on an elective basis for employers hiring individuals from one or more of nine targeted groups.

New law. For individuals beginning work for the employer after Dec. 31, 2008, the Recovery Act creates a new targeted group for the work opportunity tax credit, consisting of unemployed veterans and disconnected youth who begin work for the employer in 2009 or 2010. (Code Sec. 51(d)(14), as amended by Act Sec. 1421)

An unemployed veteran is as an individual certified by the designated local agency as someone who: (1) has served on active duty (other than for training) in the Armed Forces for more than 180 days or who has been discharged or released from active duty in the Armed Forces for a service-connected disability; (2) has been discharged or released from active duty in the Armed Forces at any time during the 5-year period ending on the hiring date; and (3) has received unemployment compensation under State or Federal law for not less than four weeks during the one-year period ending on the hiring date. A disconnected youth is defined as an individual certified by the designated local agency as someone: (a) at least age 16 but not yet age 25 on the hiring date; (b) not regularly attending any secondary, technical, or post-secondary school during the six-month period preceding the hiring date; (c) not regularly employed during the six-month period preceding the hiring date; and (d) not readily employable by reason of lacking a sufficient number of skills.

Deferral of debt forgiveness income on repurchase of debt. Gross income generally includes income realized by a debtor from the discharge of debt, subject to certain exceptions (debtors in Title 11 bankruptcy, insolvent debtors, certain student loans, certain farm debt, and certain real property business debt). Where discharge of debt is excluded from gross income under the exceptions to the general rule, taxpayers generally must reduce certain tax attributes, including net operating losses, general business credits, minimum tax credits, capital loss carryovers, and basis in property, by the amount of the discharge of debt.

These rules generally apply to the exchange of an old obligation for a new obligation, including a modification of debt that is treated as an exchange (a debt-for-debt exchange). Similarly, a debtor that repurchases its debt instrument for an amount that is less than the “adjusted issue price” of such debt instrument realizes income equal to the excess of the adjusted issue price over the repurchase price.

New law. For debt discharges in tax years ending after Dec. 31, 2008, a taxpayer can elect to have debt discharge income from the reacquisition of an applicable debt instrument after Dec. 31, 2008, and before Jan. 1, 2011, included in gross income ratably over five tax years beginning with:

- (1) for repurchases occurring in 2009, the fifth tax year following the tax year in which the repurchase occurs, and
- (2) for repurchases occurring in 2010, the fourth tax year following the tax year in which the repurchase occurs. (Code Sec. 108(i), as amended by Act Sec. 1231(a))

RIA illustration: In 2009, ABC Corp. repurchases for \$6 million notes that it issued with an adjusted issue price of \$10 million. ABC realizes \$4 million of debt discharge income, but doesn’t recognize that income in 2009. Instead, it recognizes \$800,000 of debt discharge income ($\$4 \text{ million} \div 5$) in each of the five years from 2014 to 2018, inclusive.

RIA observation: Although all of the deferred debt discharge income will eventually be recognized, the taxpayer benefits from the deferral of tax to later years. None of the taxpayer’s tax attributes have to be reduced.

For purposes of the new deferral-of-income rule, “applicable debt instrument” means any debt instrument that was issued by a C corporation, or any other person in connection with the conduct of a

trade or business by such person. (Code Sec. 108(i)(3)(A)) The term “debt instrument” is broadly defined to include a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness within the meaning of Code Sec. 1275(a). (Code Sec. 108(i)(3)(B))

A “reacquisition” means, for any applicable debt instrument, any acquisition of the debt instrument by the debtor that issued (or is otherwise the obligor under) the debt instrument, or a person related to that debtor. (Code Sec. 108(i)(4)(A))

The term “acquisition” for any applicable debt instrument includes:

- ... an acquisition of the debt instrument for cash,
- ... the exchange of the debt instrument for another debt instrument (including an exchange resulting from a modification of the debt instrument),
- ... the exchange of the debt instrument for corporate stock or a partnership interest,
- ... the contribution of the debt instrument to capital, and
- ... the complete forgiveness of the indebtedness by the holder of the debt instrument. (Code Sec. 108(i)(4)(B))

Whether a person is related to another person is determined in the same manner as under the related-person acquisition rules of Code Sec. 108(e)(4). (Code Sec. 108(i)(5)(A))

If a taxpayer elects to defer debt discharge income from a reacquisition of an applicable debt instrument, the exclusions for title 11 bankruptcy, insolvency, qualified farm indebtedness, and qualified real property business indebtedness won’t apply to the debt discharge income for the tax year of the election or any later tax year. (Code Sec. 108(i)(5)(C))

In the case of the taxpayer’s death, the liquidation or sale of substantially all the taxpayer’s assets (including in a Title 11 or similar case), the cessation of business by the taxpayer, or similar circumstances, any item of income or deduction that is deferred under the above rules (and hasn’t previously been taken into account) is taken into account in the tax year in which that event occurs (or in a Title 11 case, the day before the petition is filed). (Code Sec. 108(i)(5)(D)(i)) This acceleration rule also applies in the case of the sale or exchange or redemption of an interest in a partnership, S corporation, or other passthrough entity by a partner, shareholder, or other person holding an ownership interest in the entity. (Code Sec. 108(i)(5)(D)(ii))

Exclusion for qualified small business stock increased to 75% of gain. Under pre-Act law, noncorporate taxpayers can exclude 50% of any gain realized on the sale or exchange of qualified small business stock (QSBS) held for more than five years. For QSBS in a corporation that is a qualified business entity (QBE) during substantially all of the taxpayer’s holding period, noncorporate taxpayers can exclude 60% of the gain realized on the sale or exchange of that QSBS, if held for more than five years. This rule does not apply to gain attributable to periods after Dec. 31, 2014. A QBE is a corporation that meets the requirements of a qualified business under the empowerment zone rules during substantially all of the taxpayer’s holding period.

New law. For QSBS acquired after Feb. 17, 2009 and before Jan. 1, 2011, the Recovery Act provides that: (1) the 50% gain exclusion is increased to 75%, and (2) none of the 60% gain exclusion rules for QBE QSBS apply. (Code Sec. 1202(a)(3), as amended by Act Sec. 1241)

Thus, under the Recovery Act, the percentage exclusion for QSBS sold by an individual is increased to 75% for stock acquired after Feb. 17, 2009 and before Jan. 1, 2011.

S corporation built-in gain holding period shortened temporarily to seven years. Where a corporation that was formed as a C corporation elects to become an S corporation (or where an S corporation receives property from a C corporation in a nontaxable carryover basis transfer), the S corporation is taxed at the highest corporate rate (currently 35%) on all gains that were built-in at the time of the election if the gains are recognized during the recognition period. Under pre-Act law, the recognition period was the first ten S corporation years (or during the ten-period after the transfer). Under a special exception, the recognition period was unlimited for distributions by thrift institutions

that were deemed to be out of pre-'88 reserves. Gains are not built-in gains to the extent they are shown to have arisen while the S election was in effect or are offset by losses.

New law. For tax years beginning in 2009 and 2010, no tax is imposed under the Recovery Act on the net unrecognized built-in gain of an S corporation if the seventh tax year in the recognition period preceded the 2009 and 2010 tax years. This rule applies separately for property acquired from C corporations in carryover basis transactions. (Code Sec. 1374(d)(7)(B), as amended by Act Sec. 1251) Thus, for the 2009 and 2010 tax years, the recognition period is reduced to seven years.

The unlimited recognition period for distributions by thrift institutions that are deemed to be out of pre-'88 reserves remains unchanged. (Code Sec. 1374(d)(7)(C))

Notice 2008-83 repealed prospectively. After an ownership change, such as in a takeover, Code Sec. 382 limits the amount of a corporation's taxable income in a post-change year that can be offset by pre-change losses. However, on Sept. 30, 2008, IRS issued Notice 2008-83, 2008-42 IRB 905, which provided that a bank's losses on loans or bad debts (including deductions for a reasonable addition to a reserve for bad debts) wouldn't be treated as pre-change losses. IRS was roundly criticized in Congress for implemented this administrative action, which resulted in major tax savings for the banks (and lost tax revenue for the government), on its own.

New law. The Recovery Act provides that Notice 2008-83, shall be deemed to have the force and effect of law with respect to any ownership change (as defined in Code Sec. 382(g) occurring on or before Jan. 16, 2009, and with respect to any ownership change (as so defined) which occurs after that date, if the change (1) is pursuant to a written binding contract entered into on or before Jan. 16, 2009 or (2) is pursuant to a written agreement that was entered into on or before Jan. 16, 2009, and was described on or before that date in a public announcement or in a filing with the Securities and Exchange Commission required by reason of such ownership change, but shall otherwise have no force or effect with respect to any ownership change after Jan. 16, 2009. (Act Sec. 1261) Thus, Notice 2008-83 will have no effect for ownership changes after Jan. 16, 2009 unless one of the above exceptions applies.

Other Changes Affecting Business

... Under pre-Act law, for payments made after 2010, the federal government and the government of every state, political subdivision of a state, and instrumentality of a state or state subdivision (including multi-state agencies) making certain payments to a person providing any property or services would have been required to deduct and withhold tax from that payment in an amount equal to 3% of the payment. The Recovery Act delays the implementation of the 3% withholding requirement by one year to apply to payments after Dec. 31, 2011. (Code Sec. 3402(t), as amended by Act Sec. 1511)

... A publicly held corporation can't deduct more than \$1 million per year of applicable employee remuneration paid to a covered employee. Under Code Sec. 162(m)(5), the \$1 million deduction limit is reduced to \$500,000 for remuneration paid to covered executives—generally, the chief executive officer (CEO), chief financial officer (CFO), and the three highest paid other officers of an “applicable employer.” Under pre-Act law, the \$500,000 limit also applied to financial institutions from whom troubled assets were acquired under the Troubled Assets Relief Program (TARP) established by the 2008 Emergency Economic Stabilization Act, if the aggregate amount of acquired assets exceeded \$300 million. But if all the acquisitions were direct purchases, the Code Sec. 162(m)(5) \$500,000 limit didn't apply. Effective Feb. 17, 2009, the Recovery Act provides that each TARP recipient is subject to the Code Sec. 162(m)(5) \$500,000 compensation deduction limit during the period in which any obligation arising from TARP financial assistance remains outstanding. (Recovery Act Sec. 7001) A TARP recipient is any entity that has received or will receive financial assistance under TARP. The period in which any obligation arising from TARP financial assistance remains outstanding doesn't include any period during which the federal government only holds warrants to purchase the TARP recipient's common stock.

Tax Changes for Individuals

New Making Work Pay credit. The Recovery Act provides eligible individuals with a refundable income tax credit for tax years beginning in 2009 and 2010. (Code Sec. 36A, as added by Act Sec. 1001(a)) The credit is the lesser of (1) 6.2% of an individual's earned income or (2) \$400 (\$800 for a joint return). (Code Sec. 36A(a))

For these purposes, the earned income definition is the same as for the earned income tax credit with two modifications: (a) it does not include net earnings from self-employment which are not taken into account in computing taxable income; and (b) it includes combat pay excluded from gross income under Code Sec. 112. (Code Sec. 36A(d)(2))

The credit is phased out at a rate of 2% of the eligible individual's modified AGI (i.e., AGI increased by any amount excluded under Code Sec. 911, Code Sec. 931 or Code Sec. 933) above \$75,000 (\$150,000 for a joint return). (Code Sec. 36A(b))

RIA observation: Thus, the credit phases out completely at modified AGI of \$95,000 (\$190,000 on a joint return).

The credit is reduced by any payment received by the taxpayer under Recovery Act Sec. 2201 or any credit allowed to the taxpayer under Recovery Act Sec. 2202 (these are recovery payments under the Veterans Administration, Railroad Retirement Board, and the Social Security Administration and credit for certain government workers, as discussed below). (Code Sec. 36A(c))

An eligible individual is any individual other than: (1) a nonresident alien; (2) an individual with respect to whom another may claim a dependency deduction for a tax year beginning in a calendar year in which the eligible individual's tax year begins; and (3) an estate or trust. (Code Sec. 36A(d)(1)(A)) An individual is not eligible if he does not include his social security number on the return. For joint filers, this requirement is met if the social security number of one of the spouses is included on the return. (Code Sec. 36A(d)(1)(B))

Any credit or refund allowed or made to an individual under this provision is not taken into account as income and is not taken into account as resources for the month of receipt and the following two months for purposes of determining eligibility of the individual or any other individual for benefits or assistance, or the amount or extent of benefits or assistance, under any Federal program or under any State or local program financed in whole or in part with Federal funds. (Act Sec. 1001(c))

It is anticipated that taxpayers' reduced tax liability under the provision will be expeditiously implemented through revised income tax withholding schedules produced by IRS. These revised schedules should be designed to reduce taxpayers' income tax withheld for each remaining pay period in the remainder of 2009 by an amount equal to the amount that withholding would have been reduced had the provision been reflected in the income tax withholding schedules for the entire tax year. (Conference Report)

Economic recovery payment to certain retirees and disabled veterans. The Recovery Act provides a one-time payment of \$250 to retirees, disabled individuals and SSI recipients receiving benefits from the Social Security Administration, Railroad Retirement beneficiaries, and disabled veterans receiving benefits from the U.S. Department of Veterans Affairs. To be entitled to the \$250 payment, the individual must have been eligible for one of the four benefit programs for any month during the three-month period ending with the month which ends before the month that includes the Feb. 17, 2009 date of enactment. Thus, to be entitled to the payment, the individual must have been so eligible during November or December of 2008 or January of 2009. (Act Sec. 2201) The one-time payment is a reduction to any allowable Making Work Pay credit (see above). Treasury must begin disbursing economic recovery payments as soon as practicable, but no later than June 17, 2009 (120 days after the enactment date).

Effective Feb. 17, 2009, the Recovery Act also provides a one-time refundable tax credit of \$250 in 2009 to certain government retirees who are not eligible for Social Security benefits. (Act Sec. 2202) This one-time credit is a reduction to any allowable Making Work Pay credit (see above).

Increase in earned income tax credit. Low- and moderate-income workers may be eligible for the refundable earned income tax credit (“EITC”). Eligibility for the EITC is based on earned income, adjusted gross income, investment income, filing status, and immigration and work status in the U.S. The amount of the EITC is based on the presence and number of qualifying children in the worker’s family, as well as on adjusted gross income and earned income.

New law. The Recovery Act increases the EITC credit percentage for families with three or more qualifying children to 45% for 2009 and 2010. (Code Sec. 32(b)(3), as amended by Act Sec. 1002(a)) For example, in 2009, taxpayers with three or more qualifying children may claim a credit of 45% of earnings up to \$12,570, resulting in a maximum credit of \$5,656.50.

The Recovery Act also increases the threshold phaseout amounts for married couples filing joint returns to \$5,000 above the threshold phaseout amounts for singles, surviving spouses, and heads of households) for 2009 and 2010 (subject to a further increase in 2010 for inflation). (Code Sec. 32(b)(3)) For example, in 2009, the maximum credit of \$3,043 for one qualifying child is available for those with earnings between \$8,950 and \$16,420 (\$21,420 if married filing jointly). The credit begins to phase down at a rate of 15.98% of earnings above \$16,420 (\$21,420 if married filing jointly). The credit is phased down to \$0 at \$35,463 of earnings (\$40,463 if married filing jointly). (Conference Agreement)

Refundable child credit eased. Currently, a taxpayer receives \$1,000 tax credit for each qualifying child under the age of 17. To the extent the child credit exceeds the taxpayer’s tax liability, the taxpayer is eligible for a refundable credit (the additional child tax credit) equal to 15% of earned income in excess of a threshold dollar amount (the earned income formula). Under pre-Act law, for 2009, the earned income formula for the determination of the refundable child credit was 15% of earned income in excess of \$12,550 (as indexed for inflation).

New law. The Recovery Act modifies the earned income formula for the determination of the refundable child credit to apply to 15% of earned income in excess of \$3,000 for tax years beginning in 2009 and 2010. (Code Sec. 24(d)(4), as amended by Act Sec. 1003(a))

RIA observation: The change to \$3,000 will result in a larger credit for many taxpayers.

New American Opportunity Tax Credit for higher education costs. Under pre-Act law, individuals may claim a nonrefundable credit, the Hope credit, of up to \$1,800 (for 2009) per eligible student per year for qualified tuition and related expenses paid for the first two years of the student’s post-secondary education in a degree or certificate program. The Hope credit rate is 100% of the first \$1,200 of qualified tuition and related expenses, and 50% of the next \$1,200 of qualified tuition and related expenses. The Hope credit that a taxpayer may otherwise claim is phased out ratably for taxpayers with modified AGI between \$50,000 and \$60,000 (\$100,000 and \$120,000 for joint filers) for 2009.

New law. The Recovery Act modifies the Hope credit for tax years beginning in 2009 or 2010. (Code Sec. 25A(i), as amended by Act Sec. 1004(a)) The modified credit, called the American Opportunity Tax Credit, is up to \$2,500 per eligible student per year for qualified tuition and related expenses paid for each of the first four years of the student’s post-secondary education in a degree or certificate program. The modified credit rate is 100% on the first \$2,000 of qualified tuition and related expenses, and 25% on the next \$2,000 of qualified tuition and related expenses. (Code Sec. 25A(i)(1)) The definition of qualified tuition and related expenses is expanded to include course materials. (Code Sec. 25A(i)(3))

The credit is phased out ratably for taxpayers with modified AGI between \$80,000 and \$90,000 (\$160,000 and \$180,000 for joint filers). (Code Sec. 25A(i)(4)) The credit may be claimed against AMT. (Code Sec. 25A(i)(5))

Subject to an exception, forty percent of a taxpayer's otherwise allowable credit is refundable. No portion of the credit is refundable if the taxpayer claiming the credit is a child subject to the kiddie tax under Code Sec. 1(g). (Code Sec. 25A(i)(6))

Increased transit and vanpool transportation fringe benefit. An employee can exclude qualified transportation fringe benefits provided by an employer from his gross income and from his wages for payroll tax purposes. These include parking, transit passes, vanpool benefits, and qualified bicycle commuting reimbursements. For 2009, up to \$230 per month of parking benefits and up to \$120 per month of transit and vanpool benefits (as indexed for inflation) are excludable from income.

New law. For months beginning on or after Mar. 1, 2009 and before Jan. 1, 2011, the Recovery Act increases the monthly exclusion for employer-provided transit and vanpool benefits to the same level as the exclusion for employer-provided parking. (Code Sec. 132(f)(2), as amended by Act Sec. 1151)

Computers as education expenses under 529 plans. A person can make nondeductible cash contributions to a qualified tuition program (QTP, or 529 plan) on behalf of a designated beneficiary. The earnings on the contributions build up tax-free and distributions from a QTP are excludable to the extent used to pay for qualified higher education expenses (tuition, fees, books, supplies, equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, expenses for special needs services and room and board costs (subject to a limit) for students who are at least half-time).

New law. Under the Recovery Act, expenses paid or incurred in 2009 or 2010 for the purchase of any computer technology or equipment or Internet access or related services qualify as qualified education expenses under QTPs if such technology, equipment, or services are to be used by the QTP beneficiary or his family during any of the years the beneficiary is enrolled at an eligible educational institution. (Code Sec. 529(e)(3)(A)(iii), as amended by Act Sec. 1005(a)) Expenses for computer software designed for sports, games or hobbies do not qualify under Code Sec. 529(e)(3)(A)(iii) unless the software is predominantly educational in nature. (Code Sec. 529(e)(3)(A)(iii))

Liberalized first time homebuyer credit. Under pre-Act law, for qualifying purchases of principal residences in the U.S. after Apr. 8, 2008 and before July 1, 2009, eligible first-time homebuyers may claim a refundable tax credit equal to the lesser of 10% of the purchase price of a principal residence or \$7,500 (\$3,750 for married individuals filing separately). A taxpayer is considered a first-time homebuyer if he (or spouse, if married) had no present ownership interest in a principal residence in the U.S. during the 3-year period before the purchase of the home to which the credit applies. Eligible first-time homebuyers who purchase a principal residence after Dec. 31, 2008, and before July 1, 2009, may elect to treat the purchase as made on Dec. 31, 2008. The first-time homebuyer credit phases out for individual taxpayers with modified AGI between \$75,000 and \$95,000 (\$150,000-\$170,000 for joint filers) for the year of purchase.

Under pre-Act law, the credit for new homebuyers is recaptured ratably over fifteen years, with no interest charge, beginning with the second tax year after the tax year in which the home is purchased.

New law. The Recovery Act extends the credit so that it applies to purchases before Dec. 1, 2009. (Code Sec. 36(h), as amended by Act Sec. 1006(a)) In addition, it generally waives the recapture of the credit for qualifying home purchases after Dec. 31, 2008. This waiver of recapture applies without regard to whether the taxpayer elects to treat the purchase in 2009 as occurring on Dec. 31, 2008, which is allowed under Code Sec. 36(g). If the taxpayer disposes of the home or the home otherwise ceases to be the principal residence of the taxpayer within 36 months from the date of purchase, the pre-Act rules for recapture of the credit apply. (Code Sec. 36(f)(4)(D)) The Recovery Act also increases the maximum homebuyer credit to \$8,000. (Code Sec. 36(b))

The Recovery Act also provides that no D.C. homebuyer credit is allowed to any taxpayer with respect to a 2009 residence purchase if a first-time homebuyer credit is allowable to the taxpayer under Code Sec. 36. (Code Sec. 1400C(e)(4))

Partial exclusion of unemployment compensation. An individual generally must include in gross income any unemployment compensation benefits received under the laws of the U.S. or any State. However, under the Recovery Act, up to \$2,400 of unemployment compensation benefits received in

2009 are excluded from gross income by the recipient. (Code Sec. 85(c), as amended by Act Sec. 1007).

New temporary deduction for sales and excise taxes on car purchases. Taxpayers who itemize deductions may elect to deduct state and local general sales and use taxes instead of state and local income taxes, for tax years beginning before 2010.

New law. For purchases on or after Feb. 17, 2009 and before Jan. 1, 2010, the Recovery Act provides a deduction for qualified motor vehicle taxes. It expands the definition of taxes allowed as a deduction to include qualified motor vehicle taxes paid or accrued within the tax year. (Code Sec. 164, as amended by Act Sec. 1008) The deduction generally is allowed to itemizers. (Code Sec. 164(a)(6)) It also is allowed to those claiming the standard deduction. (Code Sec. 63(c)(1)(E))

Qualified motor vehicle taxes are State or local sales or excise taxes imposed on the purchase of a qualified motor vehicle. (Code Sec. 164(b)(6)(A)) A qualified motor vehicle is a (1) passenger automobile, light truck or motorcycle the gross vehicle rating of which is not more than 8,500 pounds and (2) a motor home. The original use of the motor vehicle must commence with the taxpayer. (Code Sec. 164(b)(6)(D)) Only taxes on that portion of the cost of qualified motor vehicle not exceeding \$49,500 may be deducted. (Code Sec. 164(b)(6)(B)) The amount of sales or excise taxes that may be treated as qualified motor vehicle taxes is phased out ratably for a taxpayer with modified AGI between \$125,000 and \$135,00 (\$250,000 and \$260,000 on a joint return). (Code Sec. 164(b)(6)(C))

The deduction for qualified motor vehicle taxes is not available to a taxpayer who elects to deduct state and local sales and use taxes in lieu of income taxes as an itemized deduction. (Code Sec. 164(b)(6)(F))

The deduction for qualified motor vehicle taxes is allowed in computing the AMT. (Code Sec. 56(b)(1)(E))